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## THE WAR REVENUE ACT OF 1917

October 3, 1913, President Wilson signed his first important revenue measure, the Underwood Tariff bill. Exactly four years later, October 3, 1917, he signed the greatest War Revenue bill yet enacted. The former was designed to raise annually about three quarters of a billion dollars for ordinary purposes. The latter is designed to raise annually over two and one half billion dollars exclusively for war purposes, that is, over and above ordinary revenues. The former bill in the first year brought in nearly \$300,000,000 from customs, a slightly greater amount from ordinary internal revenues, and only \$71,000,000 from the new income tax. The greatly increased importance of this new tax in the recent law is very significant. The latest bill, which is superimposed upon the ordinary revenue measure, is designed to get nothing worth mentioning from customs, but \$850,000,000 from the war income tax, and \$1,000,000,000 from its brother, the war profits tax. The amended revenue bill of September 8, 1916, as further amended March 3, 1917, was expected to increase the annual revenues from three quarters of a billion to a billion dollars or more, the increase being for preparedness. This latter revenue law and the new war revenue act together are expected to yield three and a half to three and three quarter billion dollars, or about five times as much as our federal taxes before the war.

This increase is immense. It would just about pay, in a single year, the total of our national debt at the end of the Civil War, or it would pay nearly three times our national debt at the time we entered this war last April. But gigantic as this increase is, it only begins to provide for the appropriations and authorizations of over \$21,000,000,000 which have already been made for the current fiscal year ending June 30, 1918.

Soon after Congress met last April, the Ways and Means Committee took up the matter of revenue for war purposes. A very hastily considered bill was passed by the House of Representatives on May 23. The Senate Finance Committee, and later the Senate itself, took up the matter more carefully and deliberately and passed a much amended bill on September 10. The conference committee labored for two weeks or more but its report was adopted promptly by both houses with very little dissent and became law October 3, as mentioned.

The House bill was estimated to yield about \$1,800,000,000

and the prevailing sentiment in the Senate indicated a reduction to \$1,500,000,000, or less. But during the consideration of the bill, Secretary McAdoo's estimates of war needs grew rapidly and, under the pressure of these greater needs, the Senate passed a bill estimated to yield \$2,400,000,000. This was slightly increased by the conference committee. The following table gives the estimated revenue from the House, Senate, and the enacted bills, respectively.

TABLE 1.—ESTIMATED REVENUE FROM THE SEVERAL BILLS.

	House Bill	Senate Bill	Enacted Bill
	(Millions)	(Millions)	(Millions)
Incomes, individual and corporate .....	\$598.7	\$842.2	\$851.0
War tax on 1916 incomes.....	108.0	.....	.....
Excess profits .....	200.0	1,060.0	1,000.0
Spirits, liquors, wines.....	151.0	207.0	193.0
Soft drinks, syrups, etc.....	20.0	11.0	13.0
Tobacco and manufactures thereof .....	68.2	56.6	63.4
Freight transportation .....	77.5	77.5	77.5
Express transportation .....	15.0	18.0	10.8
Passenger transportation .....	75.0	37.5	60.0
Pipe lines .....	4.5	4.5	4.5
Seats and berths.....	.7	2.2	4.5
Electric lights, gas, telephone service .....	30.0	.....	.....
Telegraph and telephone messages .....	7.0	7.0	7.0
Insurance .....	5.0	.....	5.0
Automobiles .....	68.0	41.0	40.0
Tires and tubes.....	12.5	.....	.....
Musical instruments, etc.....	7.0	.....	3.0
Motion picture films.....	7.0	.....	3.0
Jewelry .....	7.5	.....	4.5
Sporting goods .....	2.0	.8	1.2
Pleasure boats .....	.5	.5	.5
Perfumes and cosmetics.....	4.7	1.9	1.9
Proprietary medicines.....	8.5	3.4	3.4
Chewing gum .....	1.0	.....	.4
Cameras .....	.....	.5	.7
Admissions .....	60.0	18.0	50.0
Club dues .....	1.5	.....	1.5
Stamp taxes, etc.....	33.0	22.0	9.0
Estate taxes .....	6.0	.....	5.0
Customs duties .....	200.0	.....	.....
First-class mail matter.....	70.0	.....	70.0
Second-class mail matter.....	19.0	.....	6.0
Munition manufacturer's tax.....	.....	.....	25.0
Totals .....	\$1,868.8	\$2,411.6	\$2,514.8

The hardest fought controversies between the two houses were

over the war profits tax and the taxes on second-class mail matter. Other important differences which were not so strenuously contested were over taxes on customs, inheritances, automobiles, holding companies, and undistributed surpluses. But the fundamental controversy throughout was not the one between the two houses but the one between different members in each house; namely, the relative amount of the total war expenditures that should be raised by taxation; and its corollary, the amount of taxes that should be levied upon large incomes and wealth. The minority report of the Senate Finance Committee was devoted almost exclusively to this issue. These controversies and the more important new features of the bill will be taken up somewhat more in detail under the treatment of the several sections or titles below.

The bill as passed is composed of thirteen so-called "titles" as follows:

- I—War Income Tax.
- II—War Excess Profits Tax.
- III—War Tax on Beverages.
- IV—War Tax on Cigars, Tobacco and Manufactures thereof.
- V—War Tax on Facilities Furnished by Public Utilities and Insurance.
- VI—War Excise Taxes.
- VII—War Tax on Admissions.
- VIII—War Stamp Taxes.
- IX—War Estate Tax.
- X—Administrative Provisions.
- XI—Postage Rates.
- XII—Income Tax Amendments.
- XIII—General Provisions.

It should be kept in mind throughout the discussion of all the titles that the War Revenue act of 1917 treats the Revenue act of September 8, 1916,<sup>1</sup> as a basic law and that, with the exception of Title XII, Income Tax Amendments, and some minor matters, this new act leaves the basic act intact and levies extra taxes for war purposes. For example, Title I, War Income Tax, levies a war "normal" tax of 2 per cent on the incomes of individuals and 4 per cent on the incomes of corporations. These taxes are not in place of, but in addition to, the 2 per cent "normal" tax on both individuals and corporations as provided for in the act of September 8, 1916. Furthermore, the reduction of the individual exemptions of \$3,000 for unmarried persons and \$4,000 for heads

<sup>1</sup> Discussed in the December, 1916, issue of this REVIEW, pp. 837-850.

of families to \$1,000 and \$2,000, respectively, does not apply to the income tax of the 1916 law but only to the war income tax of the 1917 law.

There are enough exceptions to the general rule stated above, however, to make it rather confusing for the layman, and even to the initiated, to discover just what is the sum total of all taxes in many specific cases. This condition of affairs and ambiguities inherent in the nature of several matters, particularly in the definition of capital under the war excess profits title, make it very difficult to give a clear-cut and adequate presentation of the act, and they seem to leave also many opportunities for misunderstandings and even for litigation.

In addition to the war "normal" income taxes, Title I imposes also war "additional" income taxes, or surtaxes, upon the incomes of individuals (not of corporations) as indicated in the following table:

TABLE 2.—"ADDITIONAL INCOME TAXES."

1913 law (original law; now superseded)	1916 law (still in effect)	1917 law (superimposed under 1916 law)	Part of income to which applicable (in thousands of dollars)		Tax, per cent
			\$20— 50	\$20— 40	
\$20— 50	\$20— 40	\$5— 7			1
50— 75	40— 60	7— 10			2
75—100	60— 80	10— 12			3
100—250	80— 100	12— 15			4
250—500	100— 150	15— 20			5
500—any excess	150— 200				6
	200— 250	20— 40			7
	250— 300				8
	300— 500				9
	500—1,000	40— 60			10
	1,000—1,500				11
	1,500—2,000				12
	2,000—any excess				13
		60— 80			14
		80— 100			18
		100— 150			22
		150— 200			25
		200— 250			30
		250— 300			34
		300— 500			37
		500— 750			40
		750—1,000			45
		1,000—any excess			50

The recent act provides for the collection at the source of only one 2 per cent normal income tax (either that of the act of 1916

or that of the act of 1917, apparently not both) and, so far as the war income tax upon corporations is concerned, it does away with the multiple taxation of holding companies. It will be observed in Table 1 above that the bill as passed by the Senate and as finally enacted, omitted the retroactive income tax upon 1916 incomes as provided for in the House bill, and applies to 1917 and later incomes only. This feature of the House bill was unjustifiable, if not defenseless.

The War Excess Profits Tax, Title II, may be considered an extreme expansion of the Munition Manufacturer's Tax, Title III of the 1916 act; or, more properly, perhaps, of Title II of the act of March 3, 1917. The new act, however, reduces the old tax from  $12\frac{1}{2}$  per cent to 10 per cent for 1917 and discontinues it after December 31 of this year. As mentioned above, it was over the war excess profits tax that one of the principal contests between the two houses was fought. The House proposed to allow a deduction of 8 per cent upon capital invested as a normal income and to tax the income in excess of this deduction at a flat rate of 8 per cent. This is the provision of Title II of the act of March 3, 1917, which is repealed by the act of October 3, 1917. The Senate spokesmen<sup>2</sup> said that it was impracticable to ascertain the "capital invested" because of the difficulties connected with watered stock, the value of franchises, good-will, and other intangible assets. They claimed that it would be fairer and more feasible to ascertain war excess profits by deducting the average profits of the "pre-war period" (1911, 1912, and 1913) from 1917 and later profits. Allowances were to be made for exceptional cases. The data for such computations were already at hand in the returns for the corporation and income taxes for the respective years. The Senate adopted, furthermore, not an 8 per cent flat tax, but a graduated tax of from 12 to 60 per cent upon the excess. They called especial attention to the fact that the railroads would be almost entirely exempt under the House bill because the average returns upon their capital are less than 5 per cent; also, that the corporations making huge profits would not pay nearly such heavy taxes under the House measure as under the Senate bill. It will be noted in Table

<sup>2</sup> See, however, opposite attitudes of Senators Underwood and Bankhead in speeches of August 30 and August 16 respectively, *Congressional Record*, p. 7120 *et passim*.

1 above that this title of the House bill was estimated to yield less than one fifth that of the Senate bill.

The enacted law was a compromise. To arrive at taxable excess profits, there shall be deducted the average rate of profits upon current invested capital that was earned upon invested capital in the pre-war period (1911-1912-1913), provided this rate falls between 7 per cent and 9 per cent. In any case, there shall be a minimum deduction of 7 per cent. The maximum deduction is 9 per cent, if the latter amount or more was earned in the pre-war period. On the excess above the allowable deduction the following excess profits tax rates apply:

TABLE 3.—WAR EXCESS PROFITS TAXES.

On portions of net income from invested capital between: ( <i>Per cent</i> )	Rate of tax ( <i>Per cent</i> )
Deduction <sup>1</sup> and 15 .....	20
15 and 20.....	25
20 and 25.....	35
25 and 33.....	45
33 and above.....	60

<sup>1</sup> This deduction varies from 7 to 9 per cent, according to the rate of pre-war profits, as explained in the text above.

These rates apply to the excess profits, not only of corporations but also of partnerships and individuals, though corporations are allowed only a maximum deduction of \$3,000 besides that mentioned above, while partnerships and individuals are allowed \$6,000. The compensation of government officials and employees, federal, state, and local, is exempt from this tax. Exceptional cases are to be given special consideration by the Commissioner of Internal Revenue and are to have their deductions based upon the deductions of "representative" corporations, partnerships, or individuals engaged in like or similar trades or businesses.

"Invested capital" as used in this title means: (1) actual cash paid in, (2) cash value of tangible property paid for stock at time of such payment, (3) paid in or earned surplus and undivided profits at the beginning of the taxable year. Included as invested capital are the actual cash value of patents and copyrights paid for stock or shares and the bona fide cash or tangible property payments for good-will, trademarks and franchises. There are some qualifications and some differentiations between individuals, on the one hand, and corporations and partnerships on the other.

The following quoted sections show how some difficult and exceptional cases are to be handled:

Sec. 209. In the case of a trade or business having no invested capital or not more than a nominal capital there shall be levied, assessed, collected, and paid, in addition to the taxes under existing law and under this act, in lieu of the tax imposed by section two hundred and one, a tax equivalent to eight per centum of the net income of such trade or business, in excess of the following deductions: In the case of a domestic corporation, \$8,000, and in the case of a domestic partnership, or a citizen or resident of the United States, \$6,000, in the case of all other trades or business, no deduction.

Sec. 210. If the Secretary of the Treasury is unable in any case satisfactorily to determine the invested capital, the amount of the deduction shall be the sum of (1) an amount equal to the same proportion of the net income of the trade or business received during the taxable year as the proportion which the average deduction (determined in the same manner as provided in section two hundred and three, without including the \$8,000 or \$6,000 therein referred to) for the same calendar year of representative corporations, partnerships, and individuals, engaged in a like or similar trade or business, bears to the total net income of the trade or business received by such corporations, partnerships and individuals, plus (2) in the case of a domestic corporation \$8,000, and in the case of a domestic partnership or a citizen or resident of the United States, \$6,000.

For the purpose of this section the proportion between the deduction and the net income in each trade or business shall be determined by the Commissioner of Internal Revenue in accordance with regulations prescribed by him, with the approval of the Secretary of the Treasury.

From the above it will be seen that the Commissioner of Internal Revenue and the Secretary of the Treasury have very great discretionary powers; and, if these powers are upheld, they may determine somewhat arbitrarily and summarily, if need be, the "invested capital" of and, consequently, the amount of war excess profits tax due from, any individual, partnership, or corporation. These discretionary powers may prevent much litigation, and yet, if used unwisely, may cause much friction and antagonism to the law. Much the same might be said as to the extent and use of the powers of these same officials in regard to the taxes of the other titles of this act, but the maximum appears to be reached in this title.

Title III, War Tax on Beverages, increases the existing tax on distilled spirits that are in bond or that are produced or imported by \$1.10 per gallon, or if withdrawn for beverage purposes by \$2.10 per gallon. To quote a local paper, this means that the tax on whiskey jumped from \$1.10 to \$3.20 per gallon from October 3 to the next day, October 4, and that a case which

formerly sold for \$3 must now bring \$8. Popular drinks at local cafés were reported to have been raised immediately from five to ten cents each. Retailers are allowed an exemption upon 50 gallons if in stock at passing of act. The tax on perfumes containing distilled spirits is also raised by \$1.10 per gallon, and the importation of distilled spirits, except from Porto Rico and the Philippines, is prohibited.

The existing tax of \$1.50 per gallon on beer is increased by a war tax of the same amount; the taxes upon still wines, grape, brandy, and wine spirits are doubled also.<sup>8</sup>

A graduated tax of from 5 to 20 cents per gallon is laid on syrups and extracts used in the manufacture of soft drinks, and most soft drinks themselves are taxed one cent per gallon.

The extra war taxes upon tobacco and manufactures thereof, Title IV, are graduated. On cigars not weighing more than three pounds per thousand, the tax is 25 cents per thousand; if weighing not more than three pounds per thousand and retailing from 4 to 7 cents each, the tax is \$1 per thousand. These taxes on cigars increase to a maximum of \$7 per thousand on those retailing at over 20 cents each. The war tax per thousand of cigarettes not weighing over three pounds is 80 cents and upon those heavier, \$1.20. The war tax on tobacco and snuff is 5 cents per pound.

The Senate raised the House rates on liquor but lowered the rates on tobacco, claiming that the latter rates were too high for maximum revenue yields. The finally enacted bill resulted in a compromise in each case.

Title V, War Tax on Facilities Furnished by Public Utilities and Insurance, reaches sources of revenue not levied upon in this fashion in the basic act of 1916. Receipts from freight transportation are taxed 3 per cent, and those from express 1 cent for each 20 cents or fraction thereof. The carriers are made collectors of the taxes, though the purchasers of the services are to pay them. Passenger transportation is taxed 8 per cent, though commutation and season tickets for less than 30 miles and fares of less than 35 cents are exempted. Amounts paid for seats, berths, and staterooms in parlor cars or on vessels are taxed 10 per cent. Telegraph, telephone, and radio messages for which the charge is 15 cents or more are taxed 5 cents each.

<sup>8</sup> For the various rates, see bill; or "The New Revenue Act," AMERICAN ECONOMIC REVIEW, Dec., 1916, p. 845.

Insurance issued after October 31, is subject to the following taxes:

(a) Life insurance: 8 cents on each \$100, except that on industrial policies not in excess of \$500 the tax is 40 per cent of the first weekly premium.

(b) Marine, inland, and casualty insurance: 1 cent on each dollar of premium.

Reinsurance by other companies is exempt.

Under War Excise Taxes, Title VI, manufacturers and importers of the following are taxed 3 per cent on the price sold: automobiles, motor cycles, musical instruments, talking machines, jewelry, cameras, and most of the more popular sporting goods. Perfumes, cosmetics, proprietary medicines, chewing gum, et cetera, are taxed 2 per cent; moving picture films from one fourth to one half of a cent per linear foot. Graduated taxes are levied upon water-craft, also. In most cases, only half of the above rates apply to retailers' stocks on hand at the time of passage of this act.

The House bill imposed a 5 per cent tax upon the manufacturers and importers of automobiles and most other items taxed 3 per cent in the enacted bill, as mentioned in the preceding paragraph. The Senate bill substituted for the tax on the manufacturers and importers of automobiles and motor cycles an annual graduated tax upon the use, that is, upon the owner, of these vehicles. The Senate bill rates were: motor cycles, \$2.50; automobiles, the original listed retail price of which was not over \$500, \$5; \$500-\$750, \$7.50; \$750-\$1,000, \$10; and for each \$500 increase or fraction thereof up to \$3,000, \$5; above \$3,000, \$10 for each increase of \$500 in listed price. Each year, the tax on the owner was to decrease 10 per cent until 50 per cent was reached. The House tax on automobiles was estimated to bring in the most revenue the first year, but the Senate bill would probably have had as much or more effect in reducing the demand for cars and, if not, might have brought in more revenue if the bill remained in force several years.

The War Tax on Admissions and Dues, Title VII, is 1 cent for each 10 cents or fraction thereof to be paid by person paying for admission. It is provided, however, that the tax for children under twelve shall be 1 cent in every case where they are charged

admission; also, that pass holders, except bona fide employees and municipal officers upon official business, shall pay the same tax as those paying for admission. Five-cent admissions are exempt, as are ten-cent admissions within outdoor general amusement parks. Admissions, the proceeds of which inure exclusively to the benefit of religious, educational, or charitable institutions or organizations, and admissions to agricultural fairs, none of the profits of which are distributed to stockholders or members, are also exempt.

Dues and membership fees, including initiation fees, to social, athletic, and sporting clubs, where such fees or dues are in excess of \$12 per year, are subject to a tax of 10 per cent of such dues and fees. Fraternal beneficiary societies operating under the lodge system are exempt.

The taxes levied under this title are upon the several payers of admissions, dues, and fees, but they are to be collected by the recipients and to be reported monthly by the latter to the internal revenue collector. This is similar to the provisions for the payment and collection of most of the taxes under Titles III to VII of this act.

Some of the more important items of Title VIII, War Stamp Taxes, are as follows:

1. Bonds of indebtedness: 5 cents per \$100.
2. Bonds, indemnity and surety: 50 cents. When a premium is charged, 1 per cent of premium.
3. Capital stock, issue: 5 cents per share; or, if actual value exceeds \$100, 5 cents per \$100 of actual value.
4. Capital stock, sales or transfers: 2 cents instead of 5 cents as in 3 above.
5. Produce, sales of on exchange: 2 cents per \$100.
6. Drafts or checks payable otherwise than at sight or on demand, and promissory notes, 2 cents per \$100. (It will be noted that no tax is imposed upon ordinary bank checks payable at sight.)
7. Conveyance: deeds to realty, 50 cents for each \$500 or fraction thereof.
8. Custom house entries: 25 cents to \$1.
9. Entry for withdrawal from customs bonded warehouses: 50 cents.
10. Passage tickets to ports and places not in the United States, Canada, or Mexico: \$1 to \$5, depending upon cost of ticket; tickets costing \$10 or less, exempt.

11. Proxy: 10 cents.
12. Power of attorney: 25 cents.
13. Playing cards: 5 cents per pack of 54 cards.
14. Parcel-post packages: Upon every parcel transported within the United States on which the postage is 25 cents or more, a tax of 1 cent for each 25 cents or fractional part thereof.

**Title IX, War Estate Tax.** The estate or inheritance tax, a long-abandoned source of federal revenue, was reintroduced by the act of September 8, 1917.<sup>4</sup> The rates of this act were increased 50 per cent by the preparedness act of March 3, 1917, to the amounts shown in the table below. The recent House bill superimposed upon the latter law a War Estate Tax which the Senate struck out but the main features of which the conference committee restored after making a few substantial reductions at both top and bottom. The Senators argued that it was best to reserve this source of revenue for the several states. Furthermore, the burden would fall unduly heavily upon the estates of those who happened to die during the period of this special war tax, and it would be especially unfair to those who died in patriotic service. The latter criticism was met by the conferees who exempted those dying while serving in the military or naval forces of the United States during the present war, or within one year after its close, if death results from injuries or disease contracted in such service.

TABLE 4.—FEDERAL ESTATE TAXES IN EFFECT OCTOBER 4, 1917.

On portion of net estate <sup>1</sup> between	Law of March 3, 1917	Law of October 3, 1917	Total
	(Per cent)	(Per cent)	
0— \$50,000	1½	½	2
\$50,000— 150,000	3	1	4
150,000— 250,000	4½	1½	6
250,000— 450,000	6	2	8
450,000— 1,000,000	7½	2½	10
1,000,000— 2,000,000	9	3	12
2,000,000— 3,000,000	10½	3½	14
3,000,000— 4,000,000	12	4	16
4,000,000— 5,000,000	13½	4½	18
5,000,000— 8,000,000	15	5	20
8,000,000—10,000,000	15	7	22
10,000,000—more	15	10	25

<sup>1</sup> An arbitrary deduction of \$50,000 is allowed to arrive at "net estate." The taxes here indicated are on the excesses above this deduction.

<sup>4</sup> See December, 1916, issue of this REVIEW.

The House bill provided for a tariff which would have been not only a tax upon consumption, but also a source of endless confusion and difficulty. It provided for a flat increase of 10 per cent upon all existing duties and a 10 per cent duty upon all of the free list, with a few minor exceptions. As the Senate pointed out, this would have meant a combination of both specific and ad valorem duties upon all existing specific tariff dutied items. The House proposed also an excise tax on stocks of tea and coffee already in the United States.

The Senate Finance Committee struck out the tariff provisions of the House bill but substituted a "war excise tax" on stocks, importations, and domestic production of coffee, tea, cocoa, and sugar. But neither the Senate nor the conference committee upheld any of these tariffs or excises.<sup>5</sup> The House proposal of a conscription tax upon electric light, gas, and telephone service met a similar fate.

Title XI, Postage Rates, increases the rates on letters, except drop letters, to 3 cents per ounce, and on postal and post cards to 2 cents each.

The increased rates upon second-class matter precipitated one of the biggest contests connected with the bill. The House bill proposed that the zone system, already applicable to the parcels post, should apply to second-class mail also; and provided for rates for the several zones of from  $1\frac{1}{6}$  to  $4\frac{1}{3}$  cents per pound beginning November 1, 1917; and provided further that these should be increased March 1, 1918, to  $1\frac{1}{2}$  to 6 cents. The periodicals of the country were not slow to put up a fight, many of them claiming, and probably with truth, that such rates would bankrupt them, especially in view of already high costs of paper and other printing materials. Nor was it to be expected that the interests of these papers would not appeal to a sufficient number of congressmen and senators to represent them in both houses.

The Senate struck out the zone system with its high rates and raised the existing flat rate of 1 cent an ounce to  $1\frac{1}{4}$  cents. The conferees rewrote the whole section, adopting the House suggestion of a zone system for the advertising portions of second-class mail matter but increased flat rates for other portions. The rates finally adopted were as follows: (a) On the portion of publica-

<sup>5</sup> The "harmony" speech of Senator Boies Penrose in this connection is of interest to those who wish to estimate the present position of the old stand-pat protectionists. Senate speech of August 18, 1917.

tions devoted to matter other than advertising,  $1\frac{1}{4}$  cents per pound beginning July 1, 1918, and  $1\frac{1}{2}$  cents beginning July 1, 1919. If the space for advertising does not exceed 5 per cent of the total space it takes the same rate as other matter. (b) On the portion devoted to advertising, the rates for the eight zones of the parcels post system, beginning July 1, 1918, are  $1\frac{1}{4}$ ,  $1\frac{1}{4}$ ,  $1\frac{1}{2}$ ,  $2$ ,  $2\frac{1}{4}$ ,  $2\frac{1}{2}$ ,  $3$ , and  $3\frac{1}{4}$  cents, respectively. Beginning July 1, 1919, they are  $1\frac{1}{2}$ ,  $1\frac{1}{2}$ ,  $2$ ,  $3$ ,  $3\frac{1}{2}$ ,  $4$ ,  $5$ , and  $5\frac{1}{2}$  cents, respectively. Beginning July 1, 1920, they are  $1\frac{3}{4}$ ,  $1\frac{3}{4}$ ,  $2\frac{1}{2}$ ,  $4$ ,  $4\frac{3}{4}$ ,  $5\frac{1}{2}$ ,  $7$ , and  $7\frac{3}{4}$  cents, respectively. Beginning July 1, 1921, and thereafter they are,  $2$ ,  $2$ ,  $3$ ,  $5$ ,  $6$ ,  $7$ ,  $9$ , and  $10$  cents, respectively. Rates upon daily papers deposited in a letter carrier office for delivery by carriers, and the free circulation of second-class mail matter within the county of publication are left unchanged.

Periodicals entitled to be entered as second-class mail matter and maintained by and in the interests of religious, educational, agricultural, labor, fraternal, and similar organizations, none of the net income of which goes to any private stockholder or individual, are given the following flat rates:  $1\frac{1}{8}$  cents per pound beginning July 1, 1918, and  $1\frac{1}{4}$  cents beginning July 1, 1919.

The above rates are for publishers, their agents, and news-dealers. For others mailing second-class matter, the existing flat rate of 1 cent for 4 ounces, or fraction thereof, is continued. The Postmaster General is required to turn in to the general fund of the Treasury each month the estimated excess of receipts due to the revision of postage rates under this title. It is further provided that salaries of postmasters of offices of the first, second, and third classes shall not be increased after July 1, 1917, during the present war, and that the compensation of postmasters of fourth-class offices shall be computed on the basis of the rates of postage in effect prior to the enactment of this law.

**Title XII, Income Tax Amendments.** It will be recalled<sup>6</sup> that Title I of the act of September 8, 1916, was an entire rewriting of the original income tax section of the act of October 3, 1913 (Underwood bill). Title XII of the recent act consists of miscellaneous amendments to Title I of the 1916 act, the most important of which will be discussed below.

Information-at-the-source is substituted for collection-at-the-source except in the cases of (a) interest on coupon bonds and

<sup>6</sup> See December, 1916, issue of this REVIEW.

(b) incomes derived by non-resident aliens from American sources. One section apparently provides that any 1917 income tax already withheld at the source shall be returned to the individual, though local trust companies are advising withholding agents to wait for a ruling by the Secretary of the Treasury upon this point.

The Commissioner of Internal Revenue and the Secretary of the Treasury had urged the change to information-at-the-source before Senator Simmons, chairman of the Finance Committee, and other senators and congressmen took up its advocacy. Of the \$360,000,000 income tax collected last year, Senator Simmons stated that less than \$9,000,000 was collected at the source.<sup>7</sup>

The Secretary of the Treasury in his recommendation of the change, said:

I desire very earnestly to impress upon those charged with the enactment of income-tax legislation that it is the department's judgment, based upon a close observation and study of the practical workings of the "withholding" feature of the income-tax law, as well as the general requirements of administration, that "information at the source" is a foundation upon which the administrative structure must be built if the income-tax law is to be rendered most effective, and if due regard is to be paid to economy and simplicity of administration and to the imposition of no greater burden and expense upon tax payers than is necessary for effective administration.

A very large proportion of all claims for refunds under the income tax (approximately 80 per cent) arise out of excessive and erroneous withholding at the source. As the average cost of adjusting a claim for refund is \$10, a very considerable economy will result from doing away with the expenses incident to withholding at the source.

This change will relieve many withholding agents of much annoyance and expense, it will allow the taxpayer longer use of his money, and relieve him of the risk of insolvency of the withholding agent.

In many sections of the income tax title, amendments are inserted to provide for the levying of the extra war taxes and, possibly of other taxes, upon future issues of United States bonds and similar federal obligations. One amendment makes United States certificates of indebtedness and ordinary bank checks receivable for taxes.

Another amendment, applicable to both 1916 and 1917 income taxes, provides for the exemption of gifts for charitable, religious, educational, and scientific purposes, to the extent of 15 per cent of the payer's taxable net income.

<sup>7</sup> Senate speech of August 10, 1917.

Besides the exemption for heads of families, an additional exemption of \$200 is made for each dependent child under eighteen years of age.

A very ambiguous amendment provides for a tax of 10 per cent on corporation surpluses remaining undistributed six months after the close of the year. It is then provided that:

The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business or is retained for employment in the reasonable requirements of the business or is invested in obligations of the United States issued after September 1st, 1917: Provided, That if the Secretary of the Treasury ascertains and finds that any portion of such amount so retained at any time for employment in the business is not so employed or is not reasonably required in the business, a tax of fifteen per centum shall be levied, assessed, collected, and paid thereon.

It is possible that the contradictory language of the text means to provide for a penalty of 5 per cent if the improper retention is concealed and later discovered by the Secretary of the Treasury.

Excess profits taxes of the recent law are allowed as a deduction in arriving at taxable net income subject to the ordinary (1916) income tax, and presumably this applies to the war income tax also.

Income from American securities owned by foreign governments is not subject to the ordinary income tax and presumably not to the war income tax either.

There are several other ambiguities, among them the question of whether or not the income tax is applicable to the salary of the President of the United States for his present term and to the salaries of federal judges who have taken office since the passage of the original income tax of October 3, 1913. The answer turns on the significance of the word "present" in an amendment which repeats the text of a former law in all particulars except one which is relatively unimportant and not closely related to the matter in question. Originally it meant 1913. Does its repetition to amend a section by including a clause about another matter in the latest law make it mean 1917?

As indicated above these miscellaneous amendments of Title XII apply only to the ordinary (1916) income tax and not to the extraordinary taxes of the most recent revenue act, except by cross reference in some cases.

The act of October 3, 1917, takes effect on the day following

its passage, unless otherwise specially provided therein. The following exceptions to this general rule are specially provided for:

1. The collection of the 2 per cent war "normal" tax at the source is not effective, where effective at all, until January 1, 1918.

2. The taxes on cigars, tobacco, and manufactures thereof, Title IV, take effect thirty days after the passage of the act.

3. The taxes under Title V, War Taxes, on Facilities Furnished by Public Utilities and Insurance, are effective November 1, 1917, as are also the taxes on admissions and club dues and fees of Title VII.

4. The War Stamp Taxes, Title VIII, take effect December 1, 1917.

5. The new postage rates on first-class mail take effect thirty days after the passage of the act, and the second-class mail rates are changed on July 1 of each year from 1918 to 1922, inclusive.

Considering our historical precedents, both remote and recent, and the presuppositions of our senators and congressmen, as well as of their constituents, and especially the general lack of information regarding war financing, the law as passed probably comes up to what we might reasonably have expected. But great as has been the increase in taxation provided for and heavy as will be the burdens thereof, the present writer does not believe the recent act provides for as large a proportion of the total war expenditures as would be wise if the people of the country, especially the business men, were psychologically prepared for such taxation. The reasons for this opinion have been discussed more at length elsewhere,<sup>8</sup> but will be taken up very briefly a few paragraphs below.

The House bill had all the earmarks of the hasty consideration which was given it; but it did evince a willingness to meet an emergency promptly and to meet it in approximately full measure, according to the then-considered heavy demands of the administration. Although the Senate seemed disposed to reduce substantially the aggregate of the House levies, the rapidly growing estimates of war needs urged upon it by the Secretary of the Treasury resulted in its increasing the levies. Furthermore, the

<sup>8</sup> "Effects of Taxes and Bonds in War Finance," *South Atlantic Quarterly*, vol. XVI, no. 3 (July, 1917), pp. 236-247. Also in a paper presented before the American Academy of Political and Social Science, Philadelphia, Nov. 2, 1917. There have been recently several papers and brochures on this subject by others than the present writer.

Senate, and especially its finance committee, is to be commended for the careful way in which it took up the consideration of the measure, and for the marked improvements and adjustments which it made.

Among these improvements which were adopted in the final enactment of the law were the elimination of the retroactive income tax provision, the very ill-considered tariff section and the consumption taxes on light, heat, and household telephone service. The present writer does not think that the Senate Finance Committee's proposed taxes on tea, coffee, cocoa, and sugar would have reached the best available sources of revenue, but they would not have been very bad, because they would have been some inducement to economy in the use of the semi-luxuries of tea and coffee, and it is not probable that they would have effected the retail price of sugar very much under the conditions of high profits which producers are now making, and under domestic prices which are at present controlled by European markets. This would be true even if price fixation were not attempted in this country. But these taxes were struck out by the Senate and not restored by the conferees.

The elimination of the estate tax by the Senate for the reasons given was probably wise in a bill raising no larger an amount than the one enacted. There are other better available sources. It is almost certain that this source will be called upon for heavier contributions, and, in all probability, properly so, if the war continues more than a year and greater taxation is necessary. But under present conditions, and with rates of other taxes as they are, the restoration of this section by the conferees, even with one good amendment, was not an improvement.

The conferees' compromise on second-class mail rates seems wiser than the proposal of either house. There is no reason why advertising, especially so much of the objectionable advertising, should be carried at a loss to the government. The same reasoning does not hold so clearly in the case of really educational reading matter. The writer wishes, however, that there were some practical method of differentiating between various classes of more or less popular reading matter, much of which may not be very bad, but which is of doubtful social utility and hence undeserving of public subsidy.

The House tax on automobiles, radically changed by the Senate, but restored with lower rates in the enacted bill, will probably

cause less friction and be easier of administration, as well as more productive, than the Senate's proposal, but the very annoyance which would have been caused each owner by the Senate's proposal would probably have had more effect in the reduction of the number of automobiles used. There is much hazy thinking on the part of most people who advocate taxation of automobiles, gasoline, etc., to induce economy. No doubt these taxes will have some effect in this direction and are better than nothing, but they are not drastic enough, and are not likely to be soon. There is probably no other industry in this country that can be converted to war purposes so easily as the automobile industry, nor one which is making such demands upon men and raw materials needed for the war and which is supplying utilities so large a proportion of which the public could easily dispense with in times that demand economy and sacrifice. It is surprising that the government has not before this commandeered its services. In the strain which this war will put upon us, the little taxation which we have put, or are likely to put, upon automobiles, gasoline, et cetera, is comparatively futile. The manufacture of pleasure cars and the use of gasoline for such should be prohibited. The same principle applies to a number of lesser industries. Significant action has already been taken in the matter of liquor manufacture; it might well go further. The limit is what the public will stand for. One of the largest problems before us is to educate the public to the real facts and necessities of the situation, so that it will willingly do those things that are for its own ultimate best interests.

But the biggest controversies in the passage of the revenue bill were not over the above-mentioned matters, but over the rates and bases of the war income and excess profits taxes. These are by far the most important taxes in the bill, being estimated to yield together about three fourths of the entire amount, as mentioned near the beginning of this paper. The House bill provided for extra, or war, "normal" income taxes of 2 per cent on both individual and corporate incomes; the Senate and also the conferees decided upon 4 per cent for corporations. This extra amount on corporations was justified by its sponsors by the fact that they are not subject to the war "additional" income taxes as are individuals. This differentiation ignores the fact that corporation dividends, when distributed to stockholders, become subject to both the ordinary (1916 law) and war (1917 law) "addi-

“national” income taxes. These stockholders, whether of large or small, of poor or prosperous, corporations, may themselves be of all varieties of financial conditions; they may be widows, moderately well-to-do persons, or millionaires.

Much criticism was made of the high rates of the war “additional” tax as adopted by the House, but the rapidly increasing needs while the bill was under consideration caused the Senate and the conferees to raise these rates and also to apply them to smaller incomes. These war “additional” rates begin at 1 per cent on amounts above \$5,000 (instead of above \$20,000 as in case of the ordinary—1916—“additional” tax), and increase to 50 per cent of the net income in excess of \$1,000,000. That is, the total federal income taxes, exclusive of war excess profits taxes, which are to be levied upon the excess above \$2,000,000 of net incomes of individuals, are: (1) the ordinary (1916) “normal” tax of 2 per cent, and (2) “additional” tax of 13 per cent plus (3) the war (1917) “normal” tax of 2 per cent and (4) “additional” tax of 50 per cent, a total of 67 per cent. (See Table 2 above.) These taxes are very high compared with what we or other countries have been used to and some doubt the possibility of administering them efficiently. But in this connection we may quote Professor T. S. Adams:

Personally I feel very modest about all this. Had I been told in August, 1914, that England would soon be levying a normal income tax of 25 per cent; progressive income taxes which carried the upper limit to 42 per cent; and excess profits taxes rising to 60 per cent or 80 per cent, I should have repudiated the whole proposal or program as revolutionary, and should have done it with much heat and certainty. The event has proved, however, that the common legislators of England were wiser than students like myself.<sup>9</sup>

While one of the fundamental struggles relative to the war “excess” profits tax was over the rates, the most difficult matter to decide properly was the basis of this tax, or rather, the basis of the exemption, or deduction, before the tax was to apply. The big objection to the flat rate exemption of 8 per cent of invested capital of the House bill was the difficulty of ascertaining accurately the real invested capital in each case. The Senate Finance Committee made much of the admittedly great administrative difficulties this would involve, besides pointing out that the railroads would then be allowed almost entire exemption. On the other

<sup>9</sup> From a letter of September 24, 1917, to Professor E. R. A. Seligman, chairman of a committee of which the writer is a member,

hand, the proponents of the House bill and of some amendments to the Senate Finance Committee's bill urged very strongly the injustice of the exemption of pre-war profits. It was charged that those business men who first sponsored this idea wanted the years 1914, 1915, and 1916 taken as the pre-war period. To make profits of this period, which in many instances were one hundred to one thousand per cent, the basis of exemption for all future years, would almost wholly exempt the enormous profits of many of our largest corporations and would be manifestly unfair. This was so obvious that the Finance Committee adopted the years 1911, 1912, and 1913 as the pre-war period. Specific cases were pointed out to show that this selection was unfair. For example, the automobile industry was very prosperous during those years, while the lumber industry was much depressed. If three previous years were taken, the reverse was true. As a result of this opposition, the Finance Committee proposed a minimum exemption of 6 per cent and a maximum of 10 per cent of the capital invested. Though it seemed to admit it reluctantly, this was an abandonment of its chief objection to the House basis. As noted above, the final enactment was an adoption of this compromise, with the maximum and minimum changed to 7 per cent and 9 per cent, respectively, and with the different steps or brackets of the graduated rates made to relate to certain percentages of the invested capital instead of to percentages of the exemption. It should be noted in this connection that the Senate adopted high graduated rates and really made this the fairest source of war revenue very productive in contrast with the House proposal to take the comparatively insignificant flat rate of 8 per cent which would have yielded only one fifth as much, according to the estimates.

The people of this country do not appreciate how fortunate, one might truly say how lucky, we are that our income tax law has been in force since 1913, so that we have had a little experience with it and some of the administrative machinery developed. Of course we are as fortunate or possibly even more fortunate in having adopted our federal reserve system the same year. It would be well if our tax machinery could have been developed over a longer period and more gradually, but we are much better prepared in this respect than we were at the beginning of the Civil War. We are not at all certain how the machinery is going to stand the strain put upon it, but we shall be extremely interested observers and well wishers.

But some one will ask, If you are uncertain as to how the tax machinery will stand the strain, why do you say above that you do not consider the levies of the new war revenue act heavy enough? The answer is that the people best able to pay taxes in this country are not yet psychologically prepared to pay what they should and that neither they nor the masses have yet grasped the enormity of the undertaking upon which we have entered. If they had, then they would be more nearly prepared to make the sacrifices required.

To carry out what we have undertaken, if this war lasts much longer, will force sacrifices little dreamed of as yet upon nearly all of us. Who of us realizes the significance of appropriations and authorizations of \$21,000,000,000 in the first year of our participation in the war? The expenditures of the European belligerents have risen rapidly each succeeding year; but \$21,000,000,000 is just about equal to the total expenditures of Great Britain in three years of war, and her expenditures have been the heaviest of any of the Allies.

But neither this fact nor the fact that the amount is twenty-fold our usual federal taxes brings home to us what it really means. In characteristic American style we boast of the greatest country on earth and complacently take it for granted that we can do anything. What difference does ten or a hundred billion make to us? Congress can make the appropriations and authorize the taxes and bond issues, and, while they may inconvenience us slightly, still they amount to very little for this nation. Most of this is true on paper, but we haven't gotten much farther than the paper as yet.

What is accepted by most economists as the most careful investigation of our total national income, that of Professor W. I. King, puts it at \$30,000,000,000 for 1910. Professor E. Dana Durand says:<sup>10</sup>

His estimate for 1910, which I have checked with some care, was in round numbers, \$30,000,000,000. In view of the increase of population, the speeding up of industry, and the inflation of the currency, it is probable that the present figure would be around \$40,000,000,000; it might possibly be \$45,000,000,000. Needless to say, the real income has not increased in such a ratio, but we are dealing with income expressed in terms of money.

<sup>10</sup> *Financial Mobilization for War.* Papers presented at a joint conference of the Western Economic Society and the City Club of Chicago, June 21 and 22, 1917.

Out of this income our people have to live, of course. Only what they can do without can be devoted to war purposes. But if we are to raise what has already been appropriated, even if we could devote to war all that we have been investing in new capital, it is necessary that the average consumption of the nation shall be cut to two thirds or a half of what it has been. We have not seen any evidences that we are yet psychologically prepared to make such sacrifices.

But some unthinking person—and there are many of them in the United States—wanting to avoid the necessity of heavy taxation, says why not borrow what we need, unmindful of the fact that what we borrow must come out of the national income, that is, that it merely causes certain citizens, rather than others, to cut down consumption. At this writing we are in the beginning of the second Liberty Loan Campaign to raise \$3,000,000,000. Secretary McAdoo announces that we shall have to raise thirteen or fourteen billion dollars more before June 30 next. If the people of the country do not economize enough by cutting down their consumption of automobiles, liquor, tobacco, clothing, et cetera, to this extent, the only way this amount can be raised is by inflation. To avoid this inflation is one reason why we advocate heavier taxation and even the absolute prohibition of the making of many luxuries. The labor and materials devoted to them should be turned directly or indirectly to war needs, and in many cases, taxation does not effect this as rapidly as the present emergency requires. Even with heavy taxation, the recipients of many incomes will still demand luxuries.

I shall not here take the time and space to discuss the evils of inflation and how it bears down with crushing burden upon those with small and relatively fixed incomes. That has been treated at length elsewhere. Proper taxation forces economy and prevents excessive inflation. Theoretically, bonds may be sold without causing inflation, but practically I do not believe they can be on the scale that is now authorized. We should not let ourselves be misled or confused by the money medium. What the government must have ultimately is not money, but men and commodities. We must give up these things. The government must get command of them through funds secured by borrowing, or by taxing, or by both. In any case, we consumers have to do without them. The fundamental consideration in the controversy over bonds versus taxes is, Which causes the greatest and wisest economy?

Among persons of equal means, some are in a much better position to economize at this time than are others; hence, some borrowing is socially justifiable because it allows accommodation as between individuals. But the more important fact is that the man who lends the government money by buying a bond is less likely to cut down his consumption than if he pays the same amount in taxes. This for two reasons: first, because he doesn't feel so poor, since he expects to be paid back later with interest, and hence does not feel the necessity of economizing; and, second, because he can often borrow on the security of his bond, and hence really does not have to economize as he would if he had paid taxes of an equal amount. He forgets that he (or his heirs) may be taxed later to pay himself interest and principal which he will receive, though he may be successful in avoiding part of his just taxes then. To the extent that he doesn't cut down his consumption, others must do so the more.

This almost universal attempt to shirk the practice of economy as much as possible brings a pressure upon the banks which they cannot resist, and makes it necessary for them to be accommodating in order to help the government float bonds, or even to keep many men from bankruptcy. Much of the inflation of the past has been through the issue of paper money. No one now advocates this openly. But in condemning paper money some seem to overlook the fact that bank deposit inflation is just as effective and more subtle, and in our present stage of banking, the most natural thing imaginable. Despite the contentions of those who say that inflation is not a necessary accompaniment of large bond issues, all of our history and the recent and present experience of European countries indicate that it is almost inevitable. Because of the seriousness of this matter, the following quotation from Professor A. C. Miller, one of the members of the Federal Reserve Board, is given:

When the amendments which have just passed Congress, providing for a greater concentration of the gold holdings of the country in the federal reserve banks, become effective, the twelve federal reserve banks will have a normal credit-lending and note-issuing power in the aggregate of about \$2,000,000,000. Thus far, less than one-fourth of this power has been utilized in extending accommodation to the money markets of the country, whether through the member banks of the federal reserve system or otherwise through open-market operations. The system possesses, therefore, an untouched margin of lending power of some \$1,500,000,000. When it is recalled that a dollar

of reserve credit extended to a member bank by a federal reserve bank may multiply itself by fivefold or more in the lending power of the member bank, it is at once apparent that the banks composing the federal reserve system—member banks and federal reserve banks together—have a potential credit capacity for the borrowing community of some \$7,500,000,000. This is an enormous potential credit power. But it is important that we should recognize that such power has its dangers and temptations as well as its protective strength and reassurance. To the expansionist it opens alluring vistas of inflation. By its wise use, however, it is capable of becoming at critical times a factor of decisive importance in the credit operations which will have to be undertaken during the period of the war—a bed rock of strong and wise finance.

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The danger of the loan policy is that, by deluding itself with a notion that it is putting the burden onto the future, it will, through resort to fatuous and easy expedients, put the burden both on the present and on the future. This will happen if the loan policy, failing to induce a commensurate increase in the savings fund of the nation, degenerates, through the abuse of banking credit, into inflation—raising prices against the great body of consumers as well as against the government, thus needlessly augmenting the public debt, and increasing the cost of living just as taxes would. The policy of financing war by loans, therefore, will be but a fragile and deceptive and costly support unless every dollar obtained by the government is matched by a dollar of spending power relinquished by the community—in other words, will fail and develop into inflation unless the dollars which are subscribed to the bonds of the government are real dollars, the result of real savings and of real retrenchment. The danger to be feared in undertaking to finance our war by credit is that sophistry and financial legerdemain may lead us to attempt to carry the operation through as an operation in banking finance instead of as an operation in saving and investment. The doctrine is already current in the country, with the sanction of some leading bankers, that our war cannot be financed except by credit expansion running to the limits of inflation. Being dealers in banking credit, they naturally take the view that the expansion of credit in question will properly have to be an inflation of banking credit; for this is the new and most recent form of inflation which the gigantic war in Europe has been bringing to the front as a device in war finance.<sup>11</sup>

These are some of the reasons why I think that heavier taxation should be adopted; and why it is so urgent that the people be educated to see things as they really are, not as they seem to be when glimpsed through the confusing veil of the money medium.

<sup>11</sup> *Financial Mobilization for War*, pp. 140 and 145. Paper presented at a joint conference of the Western Economic Society and the City Club of Chicago, June 21 and 22, 1917.

If the taxation under the new revenue law is as heavy as can be administered efficiently now, we must educate ourselves to the real facts so that we shall be psychologically prepared to sacrifice more. Unfortunately, voluntary sacrifices are not likely to be sufficient in this great emergency; hence the desirability of drafting, so that the burden will be more equitably distributed and so that the war may be won at the least cost in lives and goods. The writer is heartily in sympathy with our part in this great war to "make the world safe for democracy," we could not keep out of it horrible as it is; but is it wise to weaken our own present fighting strength and to jeopardize our own democracy, when better methods will gain our ends much more effectively?

Roy G. BLAKELY.

*University of Minnesota.*